Proskauer

UK Tax Round Up

Edited by **Stephen Pevsner**

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For more information, please contact:

Stephen Pevsner
Partner
t: +44.20.7280.2041
spevsner@proskauer.com

Robert E. Gaut
Partner
t: +44.20.7280.2064
rgaut@proskauer.com

Catherine Sear
Partner
t: +44.20.7280.2061
csear@proskauer.com

Welcome to this month's Proskauer UK Tax Round Up. There have been a number of significant international tax developments in October including publication of the OECD secretariat's "unified approach" on Pillar 1 of its digitalisation of the economy workstream. Here in the UK, there was an interesting case decision on HMRC's guidance creating a "legitimate expectation" among other developments.

UK Case Law Developments

Reliance on HMRC's manual statement can, but didn't, give rise to legitimate expectation

In the recent judicial review case of *Roao Aozora GMAC Investment Ltd v HMRC*, the Court of Appeal (CA) considered whether HMRC was entitled to resile from a view published in its International Manual or whether such view resulted in a legitimate expectation for the taxpayer which it could rely on. While stating that a legitimate expectation could be created by HMRC's published views, the CA determined that it wasn't in this case.

The taxpayer had applied for judicial review on the grounds that a statement in HMRC's manual created a legitimate expectation that the taxpayer would be taxed in a certain way. The CA agreed with the High Court decision and dismissed the taxpayer's appeal.

Both courts agreed with the taxpayer that the statement in the manual was sufficiently clear and unambiguous as to be capable of creating a legitimate expectation. The CA also stated that, in order to be able to rely on HMRC's guidance, the taxpayer needed to show that there would be conspicuous unfairness (i.e. an abuse of power) if HMRC were to impose tax in a different manner from that set out in the manual. Previous case law has established that a high level of unfairness is necessary to override the public interest of HMRC collecting taxes.

The CA concluded that there was insufficient unfairness and detriment resulting from HMRC changing its view and not following the interpretation of the law set out in the manual. In coming to this conclusion, the CA took account of the fact that the taxpayer had engaged a professional adviser to advise it on the tax consequences of the transaction, although that of itself would not automatically cause the claim to fail. In addition, it was relevant that the relevant statement in the manual was merely HMRC's opinion of the law rather than being, for example, quasi-legislation.

This is another case which shows how difficult it is for taxpayers to successfully bring legitimate expectation claims in cases where HMRC does not follow its published views and guidance.

Other UK Developments

GAAR panel finds scheme was not a reasonable course of action and gives indication of what might be reasonable

A GAAR advisory panel opinion of 7 August 2019 was published this month. It related to directors of a company seeking to extract value from it through an employee shareholder shares (ESS) arrangement. The panel found that entering into and carrying out the ESS arrangement was not a reasonable course of action in relation to the relevant tax provisions and so fell foul of the GAAR rules.

Whilst the opinion follows previous panel opinions in agreeing with HMRC, this opinion is notable because the panel gives some indication as to what could be considered a reasonable course of action.

The arrangement in question involved the company issuing ESSs to its directors, the economic terms of which were subject to a net asset value hurdle which meant that they had little value on issue. If the hurdle was satisfied then all of the value in the company (most of it generated before the issue of the ESSs) moved from the ordinary shares already held by the directors into the ESSs. Any gain on disposal of the ESSs was exempt from capital gains tax.

The panel started by acknowledging that, in cases where different tax results arise from different choices, it can be expected (particularly where large sums are involved) for there to be financial planning and it is not unreasonable for that financial planning to be driven by desire to take the benefit of the choice on offer with the lowest tax cost. It then recognised that the use of a hurdle mechanism as part of an incentive arrangement will in many ordinary situations not be abnormal (or unreasonable), that reorganising existing share capital prior to an issue of ESSs should be expected and that, although the legislators might not have intended the ESS exemption to apply to the taxpayers given their pre-transaction ownership of the company and the value of the company, issuing shares to fall within the favourable ESS regime to them was not, in itself, unreasonable. It also said that deliberately giving up interests in a certain partnership more than a year before having the ESSs issued in order to avoid the “material interest” provision in the ESS rules was not a contrived step but simply an obvious tax planning necessity.

So while the totality of the arrangements, and, particularly, seeking to include pre-share issue value in the ESS exemption, was abnormal, contrived and unreasonable, this opinion does give some colour on the limits that will be imposed on HMRC in seeking to apply the GAAR.

Amendments to UK VAT grouping provisions from 1 November 2019

HM Treasury has made an order appointing 1 November 2019 as the day on which VAT grouping provisions in Finance Act 2019 come into force. These provisions, in summary, allow certain individuals and partnerships which control bodies corporate to be part of a VAT group with those bodies corporate. Prior to the introduction of these provisions only bodies corporate could be members of a VAT group.

International Developments

OECD proposal responding to tax challenges from the digitalisation of the economy

The OECD secretariat has published its proposal for a unified approach to Pillar 1 of its work programme on the tax challenges arising from the digitalisation of the economy. This work can be seen as a continuation of the OECD's BEPS project.

The proposal is published for consultation (open until 12 November 2019). It does not yet have consensus support of the countries in the OECD's BEPS project and is being put forward as a way to try to reach such consensus against a backdrop of three competing proposals having been proposed at earlier stages in this work programme.

The proposed Pillar 1 unified approach tackles the challenges of a highly digitised economy with a focus on consumer-facing businesses and seeks to allocate the business's "residual profits" appropriately. If agreed and implemented, the approach would introduce a taxing right based on sales in a particular territory without any need for a physical presence there. New profit allocation rules would give a share of profits to "market jurisdictions" where sales take place. These rules go beyond the arm's length principle that currently drives cross-border transfer pricing adjustments.

The proposal is that a formulaic approach would be used to allocate a proportion of the deemed residual profit of the enterprise to each market jurisdiction, determined based on group accounts. In addition, a fixed return for routine marketing and distribution functions would be attributed to the relevant jurisdiction(s) and an additional return which reflects the transfer pricing analysis.

Apportioning a share of the deemed residual profit in this way would amount to a new taxing right for market jurisdictions. This taxing right would not be limited by concepts such as whether there is a physical presence or similar, but would be based merely on sales in the particular territory.

The Pillar 1 unified approach proposal is in its early stages and it is yet to be determined exactly what the new taxing right would apply to (e.g. whether and how it would apply to financial services).

The OECD has reported to the G20 on these proposals, and also included a progress update on the Pillar 2 workstream which sits alongside this. Pillar 2 relates to a global anti-base erosion (GloBE) system aimed at ensuring minimum levels of taxation. More announcements are expected in relation to Pillar 2 in November.

The OECD considers that Pillars 1 and 2 together would lead to a significant increase in global tax revenues and redistribution of taxing rights to the correct market jurisdictions.

Luxembourg — expiry of pre-2015 tax rulings

The Luxembourg government published its 2020 budget bill on 14 October 2019. It is understood that the bill provides, among other provisions, that Luxembourg tax rulings (advance tax confirmations) issued before 1 January 2015 will expire at the end of 31 December 2019.

Taxpayers whose tax rulings are affected should consider contacting their Luxembourg tax advisers to discuss the potential consequences.

Appeals against European Commission state aid decisions for transfer pricing rulings — one upheld, one dismissed

The European General Court (EGC) has upheld a 2015 decision of the European Commission (EC) that a transfer pricing agreement (TPA) agreed between Fiat and the Luxembourg tax authorities (LTA) amounted to unlawful state aid. In another decision on the same day, the EGC found that the Dutch tax authorities' TPA with Starbucks did not constitute unlawful state aid. In both cases the TPAs purported to use the transactional net margin method (TNMM) to establish the appropriate arm's length price.

In summary, the EGC found that the EC was entitled to conclude that the LTA/Fiat TPA conferred an economic advantage on Fiat on the basis that the TNMM was incorrectly applied and a higher amount of tax would have been paid if the arm's length principle had been correctly applied. The EGC further found that the arrangements restricted competition and/or distorted trade between member states and did not agree that the EC's actions breached the principle of legal certainty.

By contrast, the EGC found that the EC had not shown that the Dutch/Starbucks TPA resulted in a lower taxable profit than would have been the case using an appropriate arm's length method and so had not shown that a selective advantage was conferred.

EU list of non-cooperative jurisdictions in tax matters updated

The Council of the European Union has announced the removal of the United Arab Emirates and the Marshall Islands from the EU's list of non-cooperative jurisdictions for tax purposes.

The EU's list of non-cooperative jurisdictions is designed to promote efforts to prevent tax fraud and tax evasion. Annex I of the list contains jurisdictions deemed to be non-cooperative in relation to tax matters (the black list). Annex II contains jurisdictions which are on a watch list but have made sufficient commitments to reform to prevent them being included in Annex I (the grey list).

The Marshall Islands will be moved to the Annex II grey list as the Council's Code of Conduct group will continue to monitor the Marshall Islands' commitments regarding exchanges of information.

In addition, Albania, Costa Rica, and Mauritius, Serbia and Switzerland have implemented the reforms necessary to enable them to be taken off the Annex II grey list.

The countries remaining on the Annex I black list are American Samoa, Belize, Fiji, Guam, Oman, Samoa, Trinidad and Tobago, the US Virgin Islands, and Vanuatu.

The Council will continue to review and revise the list regularly, and from 2020 there will be two updates per year.